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And if Juncker was Italy's best ally?

The government should not only change the Budget Law, but also demand that the EU Commission carry out its euro-area strengthening projects.

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1. Premise

The letter that Minister Tria sent on November 13 to the Vice-President and the Commissioner for Economic Affairs of the European Commission made it clear that the Italian government chose not to make any significant changes to the Draft Budget Law for 2019, despite the substantial criticisms repeatedly advanced in the previous weeks by the Commission itself. It was therefore no surprise that, in compliance with the deadlines set by the European Semester, on November 21 the European Commission launched the first formal steps for opening a procedure against Italy.

In this *Policy Brief* we emphasize that this procedure contains at least two novelties that risk causing a much more significant impact than the previous - and apparently similar - initiatives taken by the European Commission against Italy and other members of the European Union (EU) or of the euro area. This suggests that Italy's response should aim at eliminating those imbalances that have led to the opening of the procedure. Moreover, Italy's reaction must be prompted as rapidly as possible, so that it may prevent the European institutions from imposing corrections that can be so heavy as to induce high social costs. Our thesis states that, to obtain this result, it is not enough to correct the Budget Law for 2019. The Italian government must also take an active position in the negotiations aimed at redesigning Europe's economic *governance* and *policies*. This approach could strengthen the stability of our country and consequently its economic growth. Eventually, it can also contribute to a stronger convergence between the euro area economies.

In this regard, a promising basis was offered by the program of institutional and economic reforms proposed by the European Commission at the end of 2017. Those proposals have also influenced the Franco-German attempts at coordination throughout 2018. To contribute to the revival of this program and to hinge it on some cornerstones that are relevant to Italy's economic development, however, the yellow-green coalition must neither isolate itself nor become a hotbed of economic and political tensions in the European Economic and Monetary Union (EMU). It is therefore called upon to comply with the existing European rules, specifically respecting the EMU's fiscal framework, so as to restore relations of trust with the other member states of the euro area.

2. Recent events

On November 21, the European Commission claimed that the Draft Budget Law for 2019 presented by the Italian government and currently under discussion in the national Parliament involves a "particularly serious non-compliance with the fiscal recommendation[1]" addressed to Italy by the European Council at the end of June 2018 and implemented by the Council of the European Union in mid-July 2018. Based on that recommendation, approved by the Italian Prime Minister and voted by Italy's Minister of Economy, in 2019 Italy would have to adjust the disequilibrium of its 2017 public balance sheet by means of a correction of the structural deficit equal to 0.6% of Italy's GDP. On the other hand, as already stressed by the European Commission in its letter of October 23, the Italian Draft Budget Law provides for an increase in the structural deficit for the year 2019 equal to 0.8% of GDP. This difference implies that the Italian Government does not simply disregard the rule included in Italy's Constitution and related to the structural equilibrium of its balance sheet (i.e. a deficit of between 0 and -0.5% of GDP), it is also moving away from the convergence path towards this equilibrium – that is, it is moving away from its medium term objective (MTO). This justifies the Commission's statement that Italy has explicitly infringed the common rules by breaking a pact never before breached in the twenty-year history of the euro area.

In addition, the Commission claims that Italy's choices confirm its "non-compliance" with respect to the "debt criterion". In this regard, it highlights three aspects: (1) having achieved positive growth rates in 2016-2017 and in the first quarters of 2018 and - we add – estimating real growth rates of 1.2% in 2018 and – without considering the effects of the new Budget Law – of 0.9% in 2019, the Italian Government cannot justify the increase in its structural deficit being in a particularly unfavorable economic conjuncture; (2) the assumption that a budget law built around an increase of current public expenditure could induce an acceleration of the economy's growth rate from 0.9% to 1.5% is totally unrealistic; (3) taking "a major step backwards" with respect to "past reforms", the Italian government cannot invoke any budget flexibility. The EU Commission has concluded that there is a high "risk of significant deviation from the recommended path of adjustment..." and that the failure to satisfy the "debt criterion" established by the European treaty and regulation becomes very likely.

Based on these circumstances on November 21 the Commission recommended to open the excessive deficit procedure based on the violation of the debt criterion procedure: "*Overall, the analysis suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as not complied with, and that a debt-based EDP is thus warranted*". By December 6th, the Economic and Financial Committee, which is an intergovernmental technical committee within ECOFIN (i.e. the EU Council in its economic and financial composition), will have to express an opinion - predictably positive - on the recommendation of the European Commission. On the basis of that opinion, the Commission can then finally formulate: (i) its position with regard to the procedure to be applied to Italy; (ii) its proposals regarding the fiscal policy corrections to be applied to Italy to overcome the infringement; (iii) the formal framework for the effective implementation of the process. The formulation of points (i) - (iii) will take some time. Given the obligation to launch the infringement procedure within four months of the communication (which took place in early October 2018) of the relevant reference data by the Italian Statistical Office (ISTAT), the EU Council will be asked to approve (i) - (iii) of the Commission's proposal by the end of January 2019. Consequently, it is very likely that the excessive

[1] https://ec.europa.eu/info/sites/info/files/economy-finance/1263_commission_report_211118_-_italy_en_1.pdf

deficit procedure based on public debt, which will insert Italy in the corrective arm of the European fiscal rules established by the Six Pack and the so-called Fiscal Compact, will become operational after the ECOFIN meeting of January 22, 2019.

3. The gravity of the European procedure towards Italy

The recommendation put forward by the European Commission on November 21 is unprecedented for two reasons. It is the first time that the Commission itself has recommended the opening of a procedure with respect to a member state during the "autumn package" of the European Semester, that is, before the Budget Law of that country for the next year is approved by the respective Parliament and - thus – is made effective. Furthermore, it is the first time that a procedure has been opened concerning an excess of public debt rather than an excess of public deficit.

In addition to generating confusion in the domestic debate, the Commission's move creates an opportunity. The confusion, although minimized thanks to a careful selection of words used to open the procedure, lies in the fact that some members of the current Italian government are trying to attribute the reason for the Commission’s move to the management of the public balance sheet carried out by the past governments. It is clear that a procedure for excessive public debt can only refer to stocks accumulated in actual public balance sheet (the last one being that of 2017). But it should be equally clear that the structural imbalances which have accumulated in the past years have not substantially violated EU rules under the condition that they were compensated by the commitment of the 0.6% correction for 2019[2]. The Commission is explicit in attributing the responsibility for the request to open the procedure to this year’s lack of fiscal correction. On the other hand, the opportunity is presented by the fact - outlined above - that the Commission’s request will be made operational by the EU Council only in January 2019, that is, after the formulation of the final proposal by the European Commission. The Italian government would then have the right to correct the Draft Budget Law during the parliamentary process, until the formulation of the Commission's proposals regarding the fiscal policy corrections required of Italy (presumably, mid/late December 2018).

To make this possible, differently from what has happened so far, it would be necessary to provide a three-pronged response. The Italian Government should be ready to: (a) change its attitude towards Europe’s authorities and institutions; (b) renounce or postpone the implementation of the qualifying parts of the government coalition’s "contract"; (c) prepare a new Budget Law and/or make other adjustments to be able to carry out, in 2019, a correction of the structural deficit amounting to at least 0.9 percentage points of GDP. This correction would permit the government to compensate for the deficit in the current Budget Law (0.8%) and to comply with the required correction of the past structural imbalances (0.1% as mentioned in footnote 2 above). Once the different estimation of expected growth and budget dynamics is considered, the overall correction would be - roughly - equivalent to an adjustment of the nominal deficit forecast for 2019 of € 23.5 billion euro.

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[2] As already mentioned, the definition of structural equilibrium of the Fiscal Compact provides for a tolerance range between 0 and -0.5% for countries with a public debt / GDP ratio greater than 60%, or between 0 and - 1% for countries with a public debt / GDP ratio not exceeding 60%. This aspect is important because, as we will also mention below, the current government could have constrained the draft budget law to a nominal deficit / GDP ratio not exceeding 1.6% and this would have allowed for an effective correction for 2019, reduced from 0.6% to 0.1%.

The size of the corrections highlights the consequences of the second aspect of the novelty: the fact that the procedure concerning Italy refers to the violation of the debt rules rather than of the deficit criteria. This implies that the adjustments, which will be required by Italy after the effective opening of the procedure by the EU Council, will concern the debt stock (more than 131% of GDP) and not the deficit flow (2,4% or 2.9% of GDP, depending on whether reference is made to the Italian government's estimates or those of the European Commission). The disproportion between the two percentages clearly shows the greater severity of an adjustment concerning the *stock* versus one relative to the flow.

4. The European rules on public debt

In light of the previous conclusion, we should recall the European rules on public debt. In this regard, there are at least three direct or indirect rules. The first, which - in countries such as Italy with high public debt and low growth - tends to be the most severe, requires annual adjustments equal to one twentieth or slightly less (thanks to accessory correction factors) of the difference between the effective public debt / GDP ratio and the 60% threshold; which would mean in Italy, for 2019 and for several successive years, annual corrections between 65 and 57 billion euro of the public balance sheet. The second rule requires the constant realization of structural equilibria of the public balance, that is - as we said - deficits between 0 and -0.5% until the ratio of Public Debt / GDP exceeds 60%. Note that this rule tends to become just as stringent as that relating to annual adjustments equal to 1/20th of the difference between the effective debt rate and 60% only for countries that have nominal growth rates of not less than 3.2%, and have public debt / GDP ratios around (but not higher than) 120%. It follows that, for Italy, satisfying the structural balance is less expensive than not complying with the first rule. In fact, the achievement of this balance would mean, in 2019, adjustments of approximately € 42 billion compared to the current Draft Budget Law. The third rule, which is softer and which underlies the Commission's request to open a procedure for excessive government deficit based on the debt rule - due to Italy's non-compliance with the "recommended adjustment path [from the Commission itself] towards the medium-term budgetary objective ... " - would impose on Italy in 2019 (with an expected real growth rate of 0.9%) a correction of at least 23.5 billion euro compared to the current Draft Budget Law. Such a correction would be able to relocate the Italian public budget on the convergence curve towards the MTO.

The reference to these three rules clarifies that, in the most favorable and most probable case, the effective opening of the procedure requested by the Commission would require the Italian government to set aside almost indefinitely the unrealistic intentions of modifying the so-called Fornero Law by means of the 'quota 100', activating "citizens' incomes and pensions" through monthly transfers of more than 700 euro to all unemployed persons below the given thresholds of disposable income and wealth, and pursuing a tax reform in favor of the self-employed and very small non-financial firms. Modifying the Draft Budget Law for 2019 by mid-end of next December, aiming at a deficit/GDP ratio that takes into account the required structural correction of 0.1% of GDP and converges to the MTO (that is, a nominal deficit of around 1.6% of GDP) could prove to be a rewarding strategy for the Italian government. The most probable macroeconomic effect is likely to be a reduction in the political and institutional uncertainty, which would be significant enough to cause a fall in interest rates and recover the stability and confidence of Italian companies and families. This could prevent, in 2019, the Italian economy's fall back to a recession, which appears, more and more, as the inevitable consequence of the perverse effects induced by the Draft Budget Law. The main obstacle to the realization of this strategy lies in the fact that the coalition government must guarantee an equilibrium, even if inefficient, between the two different government components (the Five Star Movement and the League). A sizable structural correction would require, on the contrary, to postpone various points of the program and to thus fix a more or less explicit hierarchy among the objectives of the Five Star Movement and those of the League.

5. The impending risks

The previous rationale raises the concrete and elevated risk that the current government coalition is neither able to provide a positive response to the European Commission's decision by amending the Budget Law by mid-end of December 2018, nor make the adjustments that will - in all likelihood – be demanded by the European institutions for the excessive debt procedure against Italy (in the best of cases, € 23.5 billion for 2019 compared to the current draft budget).

If this negative prediction proved to be well founded, very worrying scenarios for Italy would appear. Italy would embark on a path never taken in the twenty-year history of the euro area: a member state would stand, in deliberate and explicit forms, in contrast to the shared rules of the economic and monetary union and would not recognize the authority of the institutions responsible for enforcing these rules. The Italian economy and society would thus be exposed to strong instability that, due to two interconnected factors, could have disastrous consequences.

The first factor concerns the reaction of international and Italian investors to Italy's eccentric position. The market tensions, which would be triggered by the Italian government's opposition to the rest of the EU (irrespective of the political color), would induce sharp rises in interest rates and huge losses for those holders of government bonds, who are forced to liquidate their investments before maturity. As a consequence, the demand for Italian government bonds would be discouraged in a year (2019) that will be characterized by the necessity of rolling over the regularly maturing issuances of government bonds, but also by increasing current borrowings, with a total coverage requirement of around 400 billion euro on an annual basis. The Italian banking and insurance sectors, which in the recent past have given a hand by absorbing national public debt bonds in the phases of poor absorption by other investors, would not be able to replicate this role. In fact, they can neither burden their already precarious balance sheets with further risks, nor can they forget that they must satisfy the new constraints imposed by the change of their '*business model* ' and by the related reallocation of a large majority of the government bonds that they already hold in the category of securities that can be liquidated only upon maturity. This reallocation, which has also avoided the immediate emergence of capital losses and capitalization inadequacies for the Italian banking sector, implies rigidities in the related financial balance sheets. It also brings greater risks with respect to the restructuring (total or partial) of the national public debt and with respect to the extreme case of Italy exiting the euro area.

In such a framework, marked by strong political-institutional uncertainty and the related and growing economic instability, there would be more tensions in financial markets that certainly would not facilitate the access to credit and other debts for businesses and that would - anyway - raise the costs (interest rates) of bank loans and other forms of debt. The combination of uncertainty and financial restrictions would discourage, as is already happening to a certain degree, the investment strategies of private firms. Losses in financial wealth - directly or indirectly - invested by households in bonds and equities would discourage private consumption. The immediate macroeconomic outcome would be Italy's relapse into a phase of recession, as already mentioned. However, the lingering threat would be a downgrade of Italian government bonds to the so-called *non- investment grade*.

Added to the incompatibility of the Italian government's position with European rules and institutions and the end of the growing demand for government bonds by the European Central Bank (ECB) (end of quantitative easing, albeit with the re-investment of proceeds from the securities previously purchased and expiring), the recession of Italy's economy and Italy's downgrading would act as an antechamber for a serious and growing difficulty for the country to find the necessary resources to refinance its public debt on national and international markets. Moreover, Italy's non-compliance with the European rules would prevent the government from activating the European mechanisms set up between 2010 and 2012 for replacing market finance with a direct financial support in case of difficulty. Even in the event of an extreme emergency, without the Italian government's explicit commitment to comply with the rules of the euro area and to implement the adjustments requested by the European institutions, it would not be possible to activate the following mechanisms: aid programs by the European Stability Mechanism (ESM) for the purchase of Italian public debt bonds on the primary and secondary markets; the so-called OMT, which would allow the ECB to purchase an indefinite amount of Italian short-medium term government bonds. Furthermore, the resulting liquidity crisis of the Italian banking sector could not be solved by having recourse to the emergency line (ELA) offered by the Bank of Italy. The current rules would prevent the ECB from providing the necessary authorization to the Bank of Italy for the ELA's implementation.

Under an institutional profile, the hypothetical but realistic situation described above would be very similar to the one Greece found itself in at the end of June 2015, after the meeting of the EU Council which triggered the rejection of the European aid program and led to the related referendum. To assess the extent of this risk, it seems useless to emphasize that the Italian economy has a much greater competitive dimension and strength than the Greek economy. In fact, these differences are significant but seem less relevant than the possible institutional similarities. The real challenge, however, consists in suggesting policy initiatives that will minimize the likelihood of the current Italian government taking a path that could lead to such dramatic results.

6. Projects to strengthen the euro area

In the hours following the rejection of the budget draft, both the European Commission and the Italian government expressed their willingness to continue the institutional dialogue and the search for an agreement. It is necessary that the apparent willingness of the Italian Government materializes, resulting in the construction of a non-short-term solution that is of common interest to Rome and Brussels. The starting point of this strategy must consist in meeting the request of the Commission for a credible Italian commitment to compliance with the rules presiding over European economic policy. To prevent it from being interpreted as a unilateral abdication of the government program, Italy's commitment could be associated with an improvement in the system of euro-area governance that would be less unrealistic than the one proposed by the yellow-green coalition through the contribution (*"A politeia for a different, stronger and fairer Europe"*) prepared by the Minister of European Affairs, Paolo Savona. The Italian economic policy strategy can be harmonized with a reform of the euro area provided that this reform contributes to decisively reducing some of the specific risks affecting Italy. Firstly, improving the governance of the euro area would make it possible to remedy the fragility of the banking system by completing the banking union and, in particular, by making available a common deposit insurance scheme (EDIS). Secondly, it would tend to reduce the risk of redenomination, which still weighs on the premium in interest rates of the weaker member states, through a euro zone budget that stabilizes national economies and stimulates investment and reforms in countries that are less convergent towards European efficiency standards.

In order for an Italian proposal along the abovementioned lines to be successful, it is necessary to reconnect with the reform project of the economic governance of the euro area advanced by the European Commission itself in December 2017, that is, as should be noted, less than a year ago. In a document that was well received at the time also by the French and German governments, the Commission put forward a series of ambitious designs starting with the establishment of a European Monetary Fund (EMF) integrated into the legislative framework of the European Union and built on the basis of the European Stability Mechanism (ESM). In the Commission's contributions the EMF should have played a more extensive and incisive role in crisis management and assistance to the member countries in difficulty. Moreover, it would have to secure the necessary finance of last resort for the Single Resolution Fund, thus providing a decisive contribution to the completion of the second pillar of the Banking Union.

Also in December 2017, the Commission proposed the institution of a European Finance Minister, who, by also acting as vice president of the EU Commission, would centralize and strengthen the coordination of the budget policies of the euro-area countries. This would help countries that are forced to limit the expansion of their public balance sheet, due to an excessively high pre-existing debt stock, to avoid being penalized by an unjustified restrictive fiscal stance of the entire euro area. Furthermore, the Commission made the request to integrate the Treaty for Stability, Coordination and Convergence, the so-called Fiscal Compact, into the European legal framework "taking into account the appropriate flexibility". Finally, it proposed the creation of a specific large euro-area budget, which would ensure the stabilization of this same area and produce a system of incentives for appropriate investments. The use of this budget could also have encouraged financial reforms and a more efficient public administration reform in the countries where it is necessary. With the aim of helping primarily the most vulnerable member countries, the euro-area budget would have had an asymmetric impact and would have thus enshrined the solidarity character of the European Economic and Monetary Union.

7. The deadlock in recent months

In the first half of 2018, no progress was made in the realization of the European Commission’s ambitious projects. Despite the support shown by both French President Emmanuel Macron and German Chancellor Angela Merkel, the various projects entered a phase of suspension. The reason for the stalemate has been attributed to factors of political uncertainty in Germany, fed by the difficult formation of a new government and by the long wait for the delicate Bavarian vote of last October, and in Italy, due to the appointment of a government with antagonistic positions towards greater European political institutional integration. Macron and Merkel made a timid attempt to revive the evolution of European governance last June through the so-called “Meseberg declaration”. However, this declaration was met with opposition from a group of EU countries led by Holland. Although traditional allies of Germany, these countries thus emphasized their disagreement with any form of risk sharing. The Italian government itself opposed the proposals, which, while favoring a risk-sharing process, required a preventive reduction of risks at a national level.

The Eurogroup meeting held last June stressed the difficulties of advancing any reforms within the euro area. The meeting reiterated the commitment introduced by ECOFIN in 2016 to observe the principle of the "appropriate sequence" between risk-reduction and risk-sharing that, in fact, imposes on weaker euro-area countries a profound reduction of their risks prior to the establishment of any risk-sharing instrument. In this regard, the Eurogroup discussed six bank risk indicators. Moreover, although without finding an agreement, it also examined "the usefulness of additional indicators, particularly in relation to banks' "sovereign risk exposure", which constituted a circumlocution for opening the door to the pressing demands of Finland, the Netherlands and Germany to attribute a positive risk, in the calculation of capital requirements, to government bonds held in bank portfolios. The proposed solution foreshadowed the introduction of a differentiated risk-weighting depending on the nationality of the issuer. Such a solution would have a negative impact not only on the stability of the entire Italian financial system but also on Italy's fiscal balances.

According to the Eurogroup, only an agreement on bank risk indicators could pave the way for the ESM's commitment to provide the last-resort financial resources required by those bank resolution processes that are not fully covered by the *bail- in* and by the Single Resolutions Fund. In the aforementioned Eurogroup meeting, it was also established that this new function of the ESM would require a preliminary verification of the effective reduction of risks and would only take place around 2024. On the other hand, it was decided to postpone to an indefinite deadline the launch of a common insurance for deposits (EDIS), which is actually considered essential for completing the Banking Union and avoiding the 'doom-loop' between sovereign risks and bank risks in the same country.

Also concerning the strengthening of the ESM's other functions, the Eurogroup of June 2018 determined a setback with respect to the intentions declared by the European Commission in December 2017. The Eurogroup affirmed the necessity that the ESM act with the rapidity required in cases of financial emergency. However, it did not address the problem raised by some member states of how to reconcile the speed of intervention and preventive approval by national parliaments regarding the granting of funds to other countries in difficulty. In addition, the Eurogroup insisted on the necessary conditionality that must precede the concession of financial aid, and in so doing, not only reaffirmed the formalization of a "full program" of management and control of the economic policy of the beneficiary country being assisted by the ESM, but also introduced the possibility of an *ex ante* restructuring of that country's public debt. At the same meeting the Eurogroup discussed – although without reaching agreement - the introduction of collective action clauses that can legally facilitate the process of restructuring the public debt of member countries; and this tool could become the 'Trojan horse' to open the door to *ex ante* debt restructuring.

Not even concerning the euro-area budget were the Eurogroup and ECOFIN finance ministers able to find a common agreement, postponing any decision to the meeting between the Heads of state and government that will be held at the beginning of December. This postponement marked a serious retreat from the position of the European Commission in December 2017; and this was bad news for countries such as Italy, which would have benefited from the stabilization of the EU's financial framework and from a connected strengthening of the risk-sharing functions.

There were meetings of the Eurogroup also in November 2018, where issues relating to the Banking Union and the ESM were once again addressed. According to what was said by President Mario Centeno, a settlement relating to the last-resort financial resources for supporting the Bank Resolution Fund was discussed. On the other hand, there was no progress regarding the definition of a common bank deposit insurance scheme and the functioning of the ESM. There is therefore no clarity on the timing decision and action of the ESM in case of emergencies and crises, or on the conditionality required to obtain its precautionary financial assistance.

8. Positive signals

The previous considerations show that, in addition to being stalled on crucial issues, the negotiation on the reform of the euro area is not going in the direction desired by Italy. The "risk sharing" proposals, which would have strengthened the convergence of weaker economies (common insurance on bank deposits, rapid precautionary intervention of the ESM if necessary, euro-area budget to support investments and reinforce the stability of divergent countries, etc.), have been placed in the background with respect to radical proposals for risk-reduction. When turned into objectives, these proposals become a real threat to the integrity of the euro area. Imposing even indirect or partial *ex ante* mechanisms for restructuring the public debt as well as introducing portfolio constraints on banks for their sovereign exposure without compensation, are not effective tools for the prevention of financial and 'real' crises in the long term. In fact, in the short term, these instruments might trigger the self-realization of the expectation of these crises and thus lead to their explosion.

Italy needs to avoid that penalizing requirements are imposed on the weakest countries of the EMU, which include, firstly, automatic or semi-automatic mechanisms for restructuring the public debt and direct or indirect criteria for the discrimination of sovereign bonds based on the nationality of the issuer. Italy should therefore act so that new developments in European economic governance reduce the risks of instability that affect, disproportionately, the weak countries through the rise in interest rates, new restrictions on bank loans, reductions in household financial wealth and consequent falls in investments and aggregate consumption. Moreover, the crucial reason for the increase in Italian public debt in the period between 2008 and 2012 was due to the increases in interest rate differentials. It follows that, instead of isolating itself from the rest of the EMU countries by increasing current public spending and opposing any European fiscal rule, the Italian government should remove the causes of the opening of the European procedure based on excessive public debt, making the necessary adjustments to its public budget. It should also support the modest growth rates of the Italian economy through the re-composition of public expenditure and taxation into a stable fiscal framework. Above all, the Italian government should seize and support every signal to rekindle the process of improving the European economic governance in such way as to stimulate growth and share risks.

A signal in the right direction was sent on November 16 by the French and German governments, which re-proposed a budget for the euro zone, assuming the provision of about 27 billion euro to support investment and reform programs in countries that are not converging towards European efficiency standards. Instead of making the most of this openness, which establishes an ideal bridge with the reform program of the European Commission advanced in December 2017, the Italian government prompted the same EU Commission to open the infringement procedure in the same days and attributed to France and Germany the desire to exclude Italy from any European agreement. The pretext was found in an obvious condition mentioned in the Franco-German project. One of the prerequisites for receiving all forms of economic and financial assistance in Europe is that the beneficiary states comply with European rules. It is therefore obvious that, in the case of a budget for the euro area, the states that intend to access the funds of this new budget need to have previously aligned their national policies with the obligations set by the framework of the European economic policy coordination, including the fiscal rules: "*Member States and Programs could only receive support by* the *Eurozone budget if they pursued* policies *that are in accordance with their obligations under the European economic policy coordination framework, including fiscal rules"*. This obvious affirmation has been captiously interpreted as a criterion for excluding Italy.

9. An opportunity for Italy

Bringing the country to the brink of political-institutional isolation at the European level and of an economic recession, the Italian government is sacrificing an important opportunity. The proposal for a euro-area budget could, in fact, open a new and promising negotiation between the European institutions and Italy founded on two pillars: a renewed, binding commitment made by the Italian government to the restoration of conditions of fiscal stability through adjustments of the public balance sheet that reintegrate Italy on the convergence curve towards the MTO; the strengthening of European governance which, building on the resources provided by the euro-area budget in favor of the most vulnerable members, makes it strongly convenient to implement the reform program drawn up by the European Commission last December. Such an agreement would lead to a reduction in the interest rate differentials between Italy and the rest of the euro area and would thus make a decisive contribution to the consolidation of Italy's public finances.

Italy therefore has a specific interest in securing that the process drawn up by the Commission less than a year ago is placed at the center of EMU initiatives. It is clear that the revival of that process will not be implemented in the meetings that the European institutions will hold this December. In the spirit of reviving the Commission's document, however, Italy should immediately emerge from isolation by going back on its choice to place itself outside the European fiscal and institutional rules and supporting the Franco-German initiative on a stronger governance. In a medium-term perspective, Italy would have a decisive role to play. Seeing the correspondence between its own interests and those of Europe, it could open a new relationship with the Commission and the other governments of the euro area. This would require that European governance meet the following criteria:

- The rebalancing of the sequence between "risk-reduction" and "risk-sharing", placing the two processes in parallel and not deferring any form of risk-sharing to an indefinite date, including a common insurance on bank deposits;
- The introduction of forms of restructuring public debts only at the request of the country in difficulty and without any form of *ex-ante* automatism or quasi-automatism;
- The consequent application of any collective action clauses, aimed at facilitating the process of restructuring public debts, only in those cases where such restructuring does not take place ex ante;
- The exclusion of any possible risk weighting on the euro area's public bonds held by the banking sector, which differentiates this risk in terms of the national issuer.[3]
- The attribution of a European legal personality to the ESM, so as to transform it into a European Monetary Fund led by the Commission's Vice-President, and to reorganize it, allowing this institution to offer ample precautionary assistance for strengthening the stability of the Eurozone without conditioning it by the preliminary assignment of a "full program" to the recipient country;

[3] It should be noted that the stated criterion complies with the international rules on banks' capital requirements.

- Sharing the principle that the euro-zone budget, destined to facilitate the convergence of the most fragile economies in the common currency, be allocated on the basis not of absolute income levels of the countries involved but the relative loss of income resulting from costs (of various kinds) imposed by the convergence process.

In the face of these six criteria, the Italian government should recognize that each and every centralized assistance coordination makes sense only if the member states concerned comply with the European rules binding the national economic policies, including the fiscal rules. Consequently, Italy should concretely commit itself to meet in the medium term the fiscal policy targets, in their current definition, and it should activate the adjustment processes that would be appropriate for the implementation of these targets also in the future.